

THE TAX EXEMPTION OF DONOR-CONTROLLED FOUNDATIONS

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Although this article explores several proposals for tax reform—specifically, proposals for change in the exempt status of foundations under the control of their donors and the donors' families—it is not intended as an exercise in fantasy. It is perfectly true that tax reform in general has again suffered its traditional demotion on the list of priorities for the Congress.¹ Reforms touching certain foundations' exemption, however, are favored by some circumstances which are not common to most suggestions for tax reform. First, the larger foundations have been the targets for four major congressional investigations in the post-war period.² While only one of the investigations has resulted in reform legislation, their frequency suggests that publicity-generating attacks on the foundations are popular in Congress. The most serious abuses of the present law of tax exemption are surely to be found among the smaller foundations, which are incapable of producing billion-dollar headlines; it may, however, be possible for serious reformers to ride on a wave of publicity about the fictitious wrongdoing charged to the giant foundations. This is not a call for bigger and better investigations; it is simply a recognition that the great

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¹ See Stern, "The Slow, Quiet Murder of Tax Reform," 227 Harper's No. 1363, p. 63 (1963); "Dillon Retreats on Tax Reforms," N. Y. Times, Oct. 17, 1963, p. 1, col. 8; Shanahan, "Tax Reform, Anyone?," N. Y. Times, Feb. 27, 1964, p. 19, col. 7.

² (1) Reported in S. Rep. No. 101, 80th Cong., 1st Sess. (1949), at least partly responsible for the enactment of the Revenue Act of 1950, 64 Stat. 906; (2) Hearings Before the Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations of the House of Representatives, 82d Cong., 2d Sess. (1952), reported in H.R. Rep. 2514, 82d Cong., 2d Sess. (1953) (Cox Committee); (3) Hearings Before the Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations of the House of Representatives, 83d Cong., 2d Sess. (1954), reported in H.R. Rep. No. 2681, 83d Cong., 2d Sess. (1954) (Reece Committee); (4) Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy (Chairman's Report to Select Committee on Small Business, H.R.), 87th Cong., 2d Sess., (first installment, 1962; second installment, 1963) (Patman Report); see Krasnowiecki & Brodsky, "Comment on the Patman Report," 112 U. Pa. L. Rev. 190 (1963).

foundations have reached the point where they must expect periodic congressional attack, and that it is an ill wind that blows nobody good.³ Another circumstance which may differentiate the reform proposals under discussion from the general run of tax reforms is the existence of a potential (although still non-vocal) interest group in support of reform: the competitors of businesses which are the corporate half-sisters of family foundations. If those arguments are unpersuasive, it can always be pleaded that would-be reformers are not supposed to despair.

I. THE FAMILY FOUNDATION: WHOSE BENEVOLENCE?

The typical family foundation⁴ does not operate a charitable enterprise such as an orphanage or a medical research program. It is above all a bank account, a repository of capital. Its donor-creator is its chief officer; since the foundation's form is normally corporate, he is the president, and perhaps he is the treasurer as well. His wife is vice-president and secretary. The other director is the donor's attorney. There are no shareholders to supervise the conduct of the foundation's affairs, nor are there any clearly-defined beneficiaries who might be interested in the management. The foundation regularly distributes its income in the form of gifts to established charities, in order to avoid running afoul of the anti-accumulations provisions of the Internal Revenue Code.⁵ It does not distribute its corpus. As a functioning charitable endeavor, it can hardly be said to exist.

Yet family foundations are enormously popular. In the latest issue of *The Foundation Directory* the "whole group of 3,520 'family and miscellaneous' foundations are estimated to possess only \$2.3 billion in assets . . ." ⁶ Even that estimate is probably conservative. The Treasury informed Congressman Patman that in 1960 over 45,000 returns on Form 990-A were filed by organiza-

³ Perhaps because of interest aroused by Congressman Patman, the Senate Finance Committee recently "decided unanimously to ask the Treasury to make a study of possible tax abuses in connection with private foundations and to report back this year if possible." "Senators Review Action on Taxes," N. Y. Times, Jan. 11, 1964, p. 27, col. 5. A similar legislative event took place more than a decade ago in Rhode Island, where the investigation of the Textron charities seemingly led to the enactment of a general reporting law, not directly connected with the abuses reported in the investigation. See Karst, "The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility," 73 Harv. L. Rev. 433, 482 n.192 (1960).

⁴ The term is used interchangeably with "donor-controlled foundation," although there are many such foundations controlled by individuals whose families have no connection with their foundations.

⁵ Int. Rev. Code of 1954, § 504(a) (1).

⁶ Andrews, Introduction to *The Foundation Directory* (2) at 9, 33 (Walton and Lewis ed. 1964). (Emphasis added.) The first edition of the *Directory* noted some

tions exempt under section 501(c)(3) of the Code.⁷ About one-quarter of all current applications for exemption under that section are estimated by officials of the Internal Revenue Service to come from foundations.⁸ The question of how many of these foundations are "family" foundations raises definitional problems. Suffice it to say that the *Directory's* estimate does not include all donor-controlled foundations in its "family and miscellaneous" group.

The rapid increase in the number of family foundations coincides with the period during which high personal income tax rates have been established and maintained. But the family foundation is only an indirect creature of the tax laws. The well-advertised tax advantages of charitable giving may be obtained just as effectively when the donor gives to operating charities such as the Red Cross or the Heart Fund. The motivation for creating one's own private foundation comes not so much from any positive inducements offered in the Code as from an awareness on the part of some givers that the retention of control over wealth is itself worth something. What the Code does permit is a contribution to a controlled charity (with a deduction of the value of the gift from taxable income), without a surrender of one of the most important attributes of ownership—management. For most purposes, a donor's gift to his own incorporated charitable pocketbook is treated in the same manner as a gift to a wholly independent charity.⁹ The

7,000 foundations which were too small to be included (assets averaging less than \$14,000); an educated guess would be that about 5,000 of those are family foundations. *Id.* at 11.

⁷ See 107 Cong. Rec. 13752 (1961); Patman Report (first installment), *supra*, note 2, at 1 (reporting this figure erroneously as the total number of tax-exempt foundations; the figure includes many more welfare or religious organizations, for example, than foundations). In 1962 the figure reached 54,751. See McGreevy, "Review of Rulings and Forms for Reporting," in Sixth Biennial N.Y.U. Conference on Charitable Foundations, at 175, 200 (1963).

⁸ Another estimate is that the "current annual rate of foundation exemption applications allowed by the Service is about 1,200." *Id.* at 184. "It is estimated that there are now between 14,000 and 15,000 tax-exempt foundations required to file Form 990-A." *Id.* at 200.

⁹ The 1964 Revenue Act does make two distinctions: (a) The limitation on the charitable contribution deduction to 20% of adjusted gross income (in § 170(b) of the Code) was extended to 30% for all contributions to charities supported by government or by public contributions. For gifts to private foundations, the limitation remains at 20%. (b) The unlimited charitable deduction—for persons who regularly give to charity nearly all their after-tax income—is allowed only with respect to contributions to (i) public charities; (ii) charities which operate actively, devoting more than half their assets and substantially all their income to active charitable operations; and (iii) charities which expend at least half of the donor's contributions on active operations or on "conduit" gifts to other public charities. Int. Rev. Code of 1954, § 170(g). See note 47, *infra*.

question is whether the exemption and deduction provisions of the tax law establishing that treatment should be revised. The conclusion reached in this article is that such a revision is overdue.

When a taxpayer whose highest personal income tax rate is fifty per cent makes a gift to his own private charity, the United States Government effectively contributes half the gift.¹⁰ This public contribution is usually explained

on the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.¹¹

The proposition may also be stated negatively: if an organization, purportedly charitable, does not engage in activities which broadly benefit the public, then the loss of governmental revenue is not offset, and exemption or deductions or both should be denied. Some portions of the present Code already reflect an understanding that the public's need for governmental revenue must be weighed against the public's interest in promoting private charity—even when there is no doubting the charity's worth to the public. The twenty to thirty per cent limitation on income tax deductions, for example, is designed to strike such a balance.¹² A similar frank recognition of the competition between these two interests ought to attend the analysis of other aspects of the law governing tax exemption.

The principal argument in favor of exemption for donor-controlled foundations is that the exemption encourages charitable giving on a scale greater than that which would result if donors were not permitted to retain control over the property given. The argument is not demonstrable, nor can it be disproved, for it rests on an estimate of the state of mind of thousands of donors and potential donors, each in a different planning context. Nevertheless, the assertion seems a good guess. Still, the assumption that there would be a reduction in charitable giving if the exemption were denied to donor-controlled foundations does not compel the conclusion that such foundations should be exempt. Against the expected losses in reduced charitable contributions must be balanced the public's expected gain in revenue from the denial of exemption and the denial of deductions (for income, gift and

¹⁰ The assumption here is that the gift itself is not large enough to change the tax rate; *i.e.*, that the 50% rate applies after deducting for the contribution.

¹¹ H.R. Rep. No. 1860, 75th Cong., 3d Sess., vol 1, p. 742 (1938).

¹² Int. Rev. Code of 1954, § 170(b)(1). *Cf.* § 170(b)(2) (5% limitation for corporations). See note 9, *supra*.

estate tax purposes) for contributions made to the controlled foundations. Just how much revenue is involved is not known, and is not likely to be known even if the Internal Revenue Service should decide to make a detailed survey of the receipts and operations of foundations.¹³ It does not seem unreasonable, however, to estimate that the average taxpayer who contributes to his own foundation deducts his contribution from income which would otherwise be taxable at a rate of at least fifty per cent. To put it another way, it is fair to assume that the public has contributed at least half of the money now in the hands of donor-controlled foundations. Whether the government could make more effective use of its lost revenue than family foundations make of their resources is another question. For the present it is enough to recognize that the discouragement of some kinds of charitable giving would not be an unmixed loss to the public.¹⁴

It is true, as Dr. Andrews has said, that "Nearly all of the large general research foundations of today began as family foundations, with limited funds oriented to the personal charities of their donors."¹⁵ But if the intended implication is that it is necessary to foster a thousand incorporated pocketbooks in order to get one Ford Foundation out of the lot, the reasoning is unpersuasive. The

¹³ Apparently in response to expressions of congressional interest, the Service began in February, 1962, and "expanded audit program" designed to audit many more exempt organizations than had previously been audited, perhaps 10,000 in 1963. See Rogovin, "Methods and Objectives of the Revenue Service's Audit Program for Exempt Organizations" in N.Y.U. Sixth Biennial Conference on Charitable Foundations, at 229, 237-40 (1963). Nonetheless, it is still true, as the Reece Committee noted, that "No comprehensive statistics are available. . . . the service would have been unable to produce complete statistics except at prohibitive cost in labor and money." H.R. Rep. No. 2681, 83rd Cong., 2d Sess. 13 (1955). Even at such cost, statistics on revenue loss would have to be based on some guessing, since the revenue lost because of deductions for contributions to foundations depends on the various tax rates applicable to all donors as well as the amounts contributed.

In an era of nearly unbroken deficits, there is great pressure on the Service, both from Congress and from the Administration, to keep revenue production at a maximum. Yet for "every man-year spent on [examinations of exempt organizations] there is a potential loss of approximately \$175,000 otherwise produced from income tax audits." Rogovin, *supra*, at 237. Repeated suggestions have been made for *statistically oriented* audits which might produce significant data concerning exempt organizations. The revenue-loss figures noted by Mr. Rogovin are part of the reason why "the facts are not easily unearthed" concerning self-dealing and other uses of foundation resources for private gain. Sacks, "Use and Misuse of the Private Foundation," in N.Y.U. Fifth Biennial Conference on Charitable Foundations 203, at 214 (1961).

¹⁴ Cf. Lynn, "The Questionable Testamentary Gift to Charity: A Suggested Approach to Judicial Decision," 30 U. Chi. L. Rev. 450 (1963).

¹⁵ Andrews, *supra* note 6, at 25.

Ford Foundation did come into existence with a relatively small endowment, before the deaths of Henry Ford I and Edsel Ford; that does not mean that there never would have been a Ford Foundation if donor control had been a ground for denial of exemption. From the point of view of the attorney who is planning a large estate, the chief advantage of having an existing organization to which property may be given at death is that the question of the organization's exemption can be settled before the gift is made. The same assurance can be obtained by establishing a foundation which is independent of the control of the donor and his family.

The family foundation is nonetheless frequently recommended as a device for avoiding the loss of control over a family business when the owner of the business dies; the case of the Ford Foundation is a regularly cited example. A gift of corporate stock to a family foundation decreases death taxes and may avoid the necessity of selling stock to outsiders in order to pay the taxes. If the family controls the foundation, the business remains free from outside influence on the management.¹⁶ Granting that such a use of a charitable organization is not of itself undesirable, one may still question whether it is necessary for the family to control the foundation in order to accomplish the desired business and estate-planning purpose. If non-voting stock is used, as the Fords used it, the gift can be made to an independent charity and management control over the business will remain in the family, which retains all the voting stock. The principal estate planning justification for using a controlled foundation will thus be satisfied. The main disadvantages to the family are two: first, the independent charitable shareholder will take an interest in the management of the business; even if it has no vote, it may have to be consulted. Second, the family will lose its management of the wealth given to charity. Whether such a loss is justified is the very question we are trying to resolve.

A related argument for exempting the family foundation has been that it permits a taxpayer whose income varies greatly from year to year to make his maximum percentage contribution to the foundation (to take his maximum deduction) each year, but to make contributions at a level rate from the foundation to the

¹⁶ See, *e.g.*, Fraser, "Charitable Giving as an Element in Planning Lifetime and Testamentary Giving," in 19th Ann. N.Y.U. Inst. Fed. Taxation 751, 799-800 (1961); Thompson, "Family Charitable Foundations-Administration," in 1957 So. Calif. Tax Inst. 665, 688-90; Casey, "Estate Planning by the Donor: Perpetuating Control; Provision for Family," in Second Biennial N.Y.U. Conference on Charitable Foundations at 131 (1955).

operating charities he wants to support. Achieving this relatively harmless result¹⁷ under the present system depends on the availability of an exempt, donor-controlled organization. Three years ago, Professor Albert Sacks suggested that the donor's need for leveling his charitable contributions might "be met by the carry-back and carry-forward device."¹⁸ Now that the Congress has made such a device available to individual donors, one of the most important justifications for the "conduit" type of foundation has disappeared.

The arguments in favor of exempting donor-controlled foundations are not decisive. They rest, finally, on the proposition that what is not plainly undesirable should not be prohibited, a proposition which is unconvincing when the issue is not prohibition but the denial of exceptionally favored treatment by the tax laws.

Against these arguments must be considered not only the revenue loss to the public, but also the opportunities and temptations created by donor control for engaging in self-dealing. The most obviously undesirable kind of self-dealing is that which results in disadvantage to the controlled charity, jeopardizing the public's interest in the charity's funds. Less obvious but equally worthy of public concern are dealings between a donor and his controlled foundation which may not harm the foundation's interests, but which do result in private advantage to the donor.

For example, the family foundation may buy, or may have contributed to it, shares in the family business. An independent foundation would be expected to make decisions concerning the management of the business on the basis of its fiduciaries' best estimate of investment and business policy. Conversely, a foundation which is not independent of its donor-creator may be caused to vote its stock (or other interest) for the purposes of the donor. A corporation which was once owned entirely by a family, but which has now "gone public," may have to decide whether to pay dividends; the family's control over the foundation may be decisive in the voting of shareholders. The abuse in such a situation is not simply that the foundation may not be managed for the maximum profit; it is, more importantly, that the public's resources are being used to prefer one private interest over another.¹⁹

¹⁷ But not absolutely harmless. Funds contributed in one year but not distributed to operating charities until later years are not truly devoted to charity while they are lying in the foundation's bank account.

¹⁸ Sacks, *supra* note 13, at 215. Even before the 1964 act, Int. Rev. Code of 1954, § 170(b) (2) provided a two-year carry-forward for corporations which made charitable contributions in excess of the 5% limit. The 1964 act extended that period to five years, and added a similar five-year carry-forward for individuals in § 170(b) (5), a new provision.

¹⁹ In 1954, the Roy Fruehaf Foundation guaranteed an investment by the Team-

When a controlled foundation buys corporate stock and votes it for the purpose of aiding the donor in a contest for control of the corporation, there are two arguments available under present law for the denial of the foundation's exemption. One is that the organization is not operated exclusively for its exempt purposes.²⁰ The other, provided that the foundation buys the stock out of its income, is that there has been either an unreasonable accumulation of income or a use of income "to a substantial degree" for non-exempt purposes.²¹ Neither argument has been tested in court, but neither seems likely to prevail. The present law is premised on the view that private advantage along the way is not objectionable so long as the funds of a controlled charity ultimately get to their charitable destination. There are occasional flashes of disagree-

sters union in stock in the Fruehaf Trailer Company, bought for the purpose of allowing Mr. Fruehaf to vote the stock in a proxy contest. See Ross, "Foundations Established by Individuals," in 14th Ann. N.Y.U. Inst. Fed. Taxation at 115, 118-19 (1956). Still another example of the use of public resources for private profit is the purchase by a controlled foundation of stock in a competitor or a supplier of the donor's business. Under present law, there is little reason to fear loss of exemption as a result of such a transaction. Cf. *Cummins-Collins Foundation*, 15 T.C. 613 (1950) (foundation exempt although it lent money to enable creditors to buy out a competitor). But cf. *Lesavoy Foundation*, 25 T.C. 924, *rev'd on other grounds*, 238 F.2d 589 (3d Cir. 1956) (use of foundation's funds to buy an outside business, assuring donor's business a source of supply, held to justify denial of exemption). Other similar abuses, none of them unknown to the world of controlled foundations, are: the sale to the foundation of hard-to-dispose-of assets; the use of the foundation to market appreciated property; the contribution of foundation funds to a city on condition that the city perform certain "public" works for the benefit of the controlling donor's business; the use of foundation funds to build a building which is leased to the donor's business at a low rental; the use of the foundation as a conduit to transfer property to children at a higher basis (donor gives appreciated stock to foundation, taking a market-value deduction, and not realizing taxable income on the appreciation; foundation sells at market value to donor's children, whose basis is thus higher than their father's); the making of loans from the foundation to a customer of the donor's business; the gift of art objects to the foundation, which permits the donor to hold the objects (in his living room) for safe-keeping; use of foundation funds to make a contribution to an exempt nursing home, which then takes the controlling donor's relative in without charge [probably, although not certainly, a violation of Int. Rev. Code of 1954, § 503(c)(6)]. For some spectacular examples of the use of foundation funds to finance the private dealings of the controlling donor, see Patman Report (second installment), *supra* note 2. For examples which have received judicial approval or disapproval, see Weithorn & Noall, "Dealings Between Donor and Foundation," in Sixth Biennial N.Y.U. Conference on Charitable Foundations at 129, 145-54 (1963). See also Patman Report (first installment), *supra* note 2, at 79-82.

²⁰ The argument rests on Int. Rev. Code of 1954, § 501(c)(3). Cf. *Best Lock Corp.*, 31 T.C. 1217 (1959); *Lesavoy Foundation*, *supra* note 19.

²¹ Either use of income would violate Int. Rev. Code of 1954, § 504(a).

ment,²² but generally the old *Trinidad* rule²³ still applies when there is no specific statutory provision to the contrary.

That rule is just as unfortunate now as it was before the 1950 Revenue Act removed some of its worst features.²⁴ It is not enough to prevent private advantage which is obtained at the expense of a foundation's exempt purposes. What is necessary is the termination of special tax privileges for anyone who uses charitable funds—public funds—for the advantage of a narrow group. The argument is not odd or unusual; the principle that tax-supported public funds and public property must be devoted to a public use, and may not be devoted to private uses, runs through the law of eminent domain and municipal corporations. When it is added that the family foundation does nothing for the public which would not also be accomplished by direct contributions from donors to operating charities,²⁵ the case against the exemption of donor-controlled foundations is amply made.

Proposals for reform legislation fall into two groups. First, there is a plain need to tighten the prohibited transactions provisions of the Code, whatever may be decided about changing the rules concerning donor control. Second, there are several possibilities for modifying or abandoning the present rule of exemption for donor-controlled foundations. The remainder of this article considers the implications of various alternative reforms of both types.

II. PROHIBITED TRANSACTIONS

A. *The Transactions Forbidden.* Even before 1950, exempt

²² As in the Tax Court's decision in *Lesavoy Foundation*, *supra* note 19.

²³ *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924), held that the religious order did not lose its exemption just because it engaged in "limited trading" which was "incidental" to the order's purposes. *Cf.* *Cone v. McGinnes*, 63-2 USTC ¶ 9551 (E.D. Pa.) (religious bookstore).

²⁴ By taxing the unrelated business income of charities, Int. Rev. Code of 1954, §§ 511-14, and by forbidding the unreasonable accumulation of their income, Int. Rev. Code of 1954, § 504(a)(1). See Note, "The Modern Philanthropic Foundation: A Critique and a Proposal," 59 *Yale L.J.* 477, 492-97 (1950).

²⁵ There are a few family foundations which are themselves operating charities, with professional staffs and regular programs for running homes for the aged, making scholarship awards and the like. The dangers of abuse of the tax exemption are lower in such cases, not only because most institutional charities are under the supervision of state agencies, but also because they are often related to particular potential beneficiaries who take an interest in what they are doing. As to such donor-controlled foundations, proposals for taking away the exemption are probably unfounded. Such foundations are few enough in number, however, that it may be more trouble to exempt them than they are worth—particularly since the majority of such foundations would no doubt convert to "independence" upon the adoption of a rule which denied exemption to donor-controlled foundations.

foundations were required to be "organized and operated *exclusively* for" their charitable, etc., purposes, and "no part" of their net earnings might inure "to the benefit of any private shareholder or individual" ²⁶ These two complementary provisions were used to deny exemption to organizations which engaged in activities rather similar to those proscribed by the prohibited transactions section of the 1950 act. ²⁷ Thus, in *Mabee Petroleum Corp. v. United States*, ²⁸ a feeder corporation, otherwise probably exempt, was held not to be exempt because it had agreed to pay a salary of \$100,000 per year for fifteen years to the man who was its president and manager. The Fifth Circuit agreed with the District Court that the salary was unreasonably high, and that "such payments resulted in the inurement of a part of the net earnings of" the corporation to the president. ²⁹ The court added: "We think it doubtful whether comparable services would have cost as much had they been acquired in an arms-length transaction from an outside source." ³⁰

After some colorful hearings, ³¹ the House of Representatives passed a revenue revision bill including a prohibited transactions provision which would have denied exemption unless the organization was *operated* so that:

(A) no part of its income or corpus is loaned to;

(B) no compensation, other than a reasonable allowance for salaries or other compensation for personal services actually rendered is paid to;

²⁶ Int. Rev. Code of 1939, § 101(6); now Int. Rev. Code of 1954, § 501(c)(3). (Emphasis added.)

²⁷ Int. Rev. Code of 1939, § 3813; now Int. Rev. Code of 1954 § 503(c).

²⁸ 203 F.2d 872 (5th Cir. 1953) (2-1 decision).

²⁹ *Id.* at 875.

³⁰ *Id.* at 876. Cf. Gemological Institute of America, 17 T.C. 1604 (1952), *aff'd per curiam*, 212 F.2d 205 (9th Cir. 1954) (exemption denied to the Institute because it paid the man who was its dominant figure a salary of \$4,500 per year plus 50% of its net profits); Stevens Bros. Foundation, Inc., 39 T.C. 93 (1962), *aff'd on all exempt org. grounds, rev'd as to other issues*, 324 F.2d 633 (8th Cir. 1963), *cert. denied*, 84 S. Ct. 1135, *rehearing denied*, 84 S. Ct. 1179 (1964) (foundation participated in construction projects and so was not operated exclusively for charitable purposes; no mention of prohibited transactions section). For similar holdings based on pre-1950 law, see Lesavoy Foundation, *supra* note 19; Best Lock Corp., *supra* note 20 ("substantial activities" in behalf of creator; also involved post-1950 years). Cf. Texas Trade School, 30 T.C. 642 (1958) (excessive rent paid by a school to four of its officers and another man); Cleveland Chiropractic College, 21 CCH Tax Ct. Mem. 1 (1962), *aff'd*, 312 F.2d 203 (8th Cir. 1963). *But cf.* Home Oil Mill v. Willingham, 68 F.Supp. 525 (N.D. Ala. 1946).

³¹ Hearings Before Subcommittee of Committee on Interstate and Foreign Commerce, U.S. Senate, 80th Cong., 2d Sess. (1948), reported in S. Rep. No. 101, *supra* note 2. See Note, *supra* note 24.

(C) no part of its services is made available on a preferential basis to;

(D) no substantial purchase of securities or any other property is made by it from; and

(E) no substantial part of its securities or other property is sold to

substantial donors, officers or trustees of the organization, or to members of their families or to corporations under their control (defined to mean fifty per cent stock ownership). The same standards were required to be made a part of the governing instrument of an exempt organization in order for a gift to the organization to be deductible.³²

The House bill thus made self-dealing by charitable donors and fiduciaries a ground for denial of exemption, without reference to the fairness of the dealings. In choosing a rule of strict prohibition, the House bill simply adopted well-established principles of trust law. A trustee who is guilty of self-dealing which has not been ratified by the beneficiary (and in the case of a charity, there is no one to ratify) is an insurer for any losses incurred by the trust, and is accountable for any gains which he receives.³³ The House bill accepted what the law of trusts had recognized for centuries: it is easier to forbid all self-dealing than it is to police all trustees' conduct in the hope of catching those who have abused their trust.

The Senate's version of the prohibited transactions provision in 1950 was superficially appealing. The Senate Finance Committee reported:

Your committee is in sympathy with the goals sought by the above provisions of the House bill but believes they would be unduly harsh in their application. No objection is seen to engaging in transactions with donors if these transactions are carried out at arm's length.³⁴

To remove the "harshness" of the House bill, the Senate proposed to prohibit loans to donors, etc., only if they should be made without adequate security; to prohibit purchases by donors from exempt organizations only if the consideration should be inadequate; and to prohibit sales by donors to exempt organizations only if the consideration should be excessive. The Senate's version—which was enacted as part of the 1950 act and is now embodied in the Code as section 503(c)—amounted to little more than embroidery on the existing requirement of exclusive organization

³² The bill is reprinted in 1950-2 Cum. Bull. 469-73.

³³ See generally 2 Scott, *Trusts* § 206 (2d ed. 1956).

³⁴ Reprinted in 1950-2 Cum. Bull. 510.

and operation for charitable purposes and the existing prohibition on diversion of an exempt organization's net income to a private individual. When the Senate removed the House bill's "harshness," it removed all independent effect from the prohibited transactions provisions. The Internal Revenue Service has given ample demonstration of this judgment; the nearly invariable practice of the Service, when it comes across dealings which might be called prohibited transactions, is to base its revocation of exemption on the general terms of section 501(c)(3) as well as the prohibited transactions ground.

Not only does the prohibited transactions section have no independent vitality as a protection for an organization's exempt purposes; it may even be argued that the addition of these provisions to the Code gives some encouragement to conduct of questionable desirability. In speaking of the companion provision of section 504, the Tax Court has properly remarked that the Code's denial of exemption for unreasonable accumulations "would seem to recognize the possibility of an exempt organization making reasonable accumulations."³⁵ So also, the prohibition on loans for less than "adequate" security and "reasonable" interest may encourage the making of loans which qualify under section 503(c)(1) but which are nonetheless not the best available investment for the exempt organization. Yet it will take a strong showing of abuse to convince a court that such a "permissible transaction" justifies revocation of the exemption. If it were not for the danger that precisely the wrong inference might be drawn, it is arguable that the prohibited transactions rules should be repealed, so that the courts might spell out their own principles of fiduciary duty within the general framework of section 501(c)(3).

Even if it might be assumed that the prohibited transactions section has some force of its own, the vagueness of the section's prohibitions detracts from its usefulness. The adequacy of security and the reasonableness of an interest rate, for example, are matters about which business judgments differ. "The money market" is an abstraction which is convenient for some purposes, but it hinders analysis if it is allowed to obscure the fact that on a given day in a given community different lenders will be prepared to lend money at different rates of interest and upon security which varies

³⁵ John Danz Charitable Trust, 32 T.C. 469, 479 (1959), *aff'd on other grounds*, 284 F.2d 726 (9th Cir. 1961). *But cf.* Kenner v. Commissioner, 318 F.2d 632 (7th Cir. 1963), holding that the exemption of hospitals, etc., from the predecessor of § 503 did not work a similar exemption from the provisions of the predecessor of § 501(c)(3).

in form and amount.³⁶ If "adequate" security and "reasonable" interest are meaningful at all in such a context, they must mean something like "the lowest interest rate and the least security which a borrower might be required to give to a commercial or other lender, other conditions being equal." That definition would leave the provision as a protection against only the most flagrant and obvious breaches of fiduciary duty, but insistence on a higher standard is hard to square with the terms of the Code. Similar arguments may be made as to the prohibited transactions provisions dealing with compensation for services and self-dealing other than loans. They add up to a lowest-common-denominator standard of enforcement.

Apart from the uncertainty inherent in its use of concepts of reasonableness, the prohibited transactions section may be faulted for other omissions and ambiguities. There is a special prohibition against unfair loans from the foundation to a condemned person, for example, but no corresponding prohibition against unfair loans from a condemned person to the foundation—say, at an excessive interest rate. Such transactions may have been left out in 1950 because they were (and are) so clearly violative of section 501(c)(3), or because the House bill was aimed at absolute prohibitions against some forms of self-dealing; there has been no suggestion that *all* loans by a donor to his foundation be prohibited.³⁷ Presumably an unfair transaction of this kind would amount to a "diversion" of the foundation's income or corpus within the meaning of section 503(c)(6), but—given the present orientation of the section—there is no good reason for making specific reference to one kind of loan and not to the other.³⁸

³⁶ See Donald G. Griswold, 39 T.C. 620 (1962). These and other requirements of the prohibited transactions provisions are ably analyzed in Young, "Donor Foundation Dealings," in 22nd Ann. N.Y.U. Inst. Fed. Taxation 965 (1964).

³⁷ During the first year of operation, while foundations have been awaiting their exemption letters, donor-to-foundation loans have been common. Such a foundation needs some funds to get started, but the donor is reluctant to make substantial contributions pending a determination of deductibility. The one-year wait was abandoned by the Service last year. Rev. Proc. 63-30, 1963 Int. Rev. Bull. No. 52, at 51.

³⁸ The word "diversion" has been read by one worried commentator to forbid a purchase of property by a foundation to be paid for out of the property's income, as when a condemned person sells stock to his foundation, reserving the right to apply future dividends to the purchase price. See Powell, "Problems of the Tax Exempt Organization," in 13th Ann. N.Y.U. Inst. Fed. Taxation at 807, 813 (1955). It is hard to see why § 503 should cause any more concern in this regard than the provision of § 501(c)(3) that no part of the income may inure to the benefit of a private individual. Surely the "diversion" portion of § 503 should be limited to unfair diversions, in line with the canon *ejusdem generis*. See Weyher & Bolton, "Loss of Charitable Status Because of Prohibited Transactions and Unreasonable Accumula-

Another omission relates to the case of the family foundation which owns stock in a corporation. When the corporation lends money to the donor-creator of the foundation, should there be a similar requirement of adequacy of security and interest? Or have we now reached the limit to which the tax law should be stretched in the interest of fiduciary duty?³⁹

The prohibited transactions section as it now stands seems to have been drafted on the optimistic assumption that exempt organizations would be subjected to regular audits of a fairly detailed nature. The vague standards of reasonableness are flexible enough so that only the most careful scrutiny of an organization's records is likely to turn up evidence of a violation—and even under those conditions there will be violations which are missed. The absence in most states of any effective supervision of private charities by state officials⁴⁰ makes the discovery of prohibited transactions difficult, for the Internal Revenue Service has never been able to devote enough personnel to exempt organizations to do a comprehensive job of policing them.⁴¹ Congress must decide whether permitting what the Senate committee hopefully called "arm's

tions," in Second Biennial N.Y.U. Conference on Charitable Foundations 55, 60-62 (1955). *Accord*, Shiffman Foundation, 32 T.C. 1073 (1959).

³⁹ By reaching, one may argue that § 503(c)(1) contains two other loopholes: (1) Suppose a donor lends money to his own controlled corporation without security and at no interest, and then contributes the note to his foundation. Is it really the foundation which lends the money? The only abuse in such a situation comes at the time the donor takes an income tax deduction for his contribution; if the note is valued at its face value, then the public loses, but if the note is properly discounted to its commercial value, there is no abuse. (2) It is apparently possible to read this language to mean that "In order to fall within the provision, the loan must be both inadequately secured and bear a rate of interest lower than reasonable." Powell, "Foundations: Prohibited Activities," in 14th Ann. N.Y.U. Inst. Fed. Taxation at 61, 67 (1956). Although the wording of the section is plainly opposed to the suggested reading, perhaps—assuming more drastic changes are not to be made—the language should be amended to make unmistakably clear that both reasonable interest and adequate security are required when a foundation makes a loan to a condemned person.

⁴⁰ See Taylor, Public Accountability of Foundations and Charitable Trusts (1953); Karst, *supra* note 3; D'Amours, "State Supervision of Charities: Present Status," 4 N.H. Bar. J. 76 (1962); Fremont-Smith, "Government Supervision and Accountability of Foundations," in Sixth Biennial N.Y.U. Conference on Charitable Foundations, at 69 (1963). Congressman Patman, noting past inadequacies in state supervision, has said: "Consideration should be given to a [federal] regulatory agency for the supervision of tax-exempt foundations." Patman Report (first installment), *supra* note 2, at 134.

⁴¹ *But see* Rogovin, *supra* note 13. The information return form (990-A), has been modified in order to improve the required disclosure of certain transactions of exempt organizations. See McGreevy, *supra* note 7, at 192-213.

length" transactions⁴² is sufficiently important to justify either the toleration of transactions which are *not* the equivalent of arm's length dealings or the high cost of enforcing the present standards. One or the other of these two alternatives is inevitable if the law remains as it is.

Paragraphs (3) and (6) of section 503(c), forbidding the foundation to make its services available to a condemned person on a preferential basis or to divert its income or corpus substantially to him, should no doubt be retained as catch-all provisions. The reasonable compensation limitation probably cannot be made more specific, although as the language now stands it invites an interpretation which reads in the case law on corporate officers' salaries.⁴³ The issue in the case of a foundation is not related to the special corporate problem of salaries as a substitute for dividends, and there is no reason to assume that the same considerations govern the reasonableness of salaries, but to add a phrase like "in view of the duties performed" would no doubt be considered a redundancy.

It is clear, however, that the law should not remain unchanged. The 1950 House bill, if adopted now, would change the other three paragraphs of section 503(c), forbidding all foundation-to-donor loans,⁴⁴ all purchases⁴⁵ and all sales⁴⁶ of the self-dealing variety. Those changes are justified, regardless of any legislative attack on donor control. While the withdrawal of exemption from donor-controlled foundations would go far to reduce the temptation and the opportunity for self-dealing, the probable availability of informal control arrangements which would satisfy any legislative definition of independence make it necessary to prohibit self-dealing in a separate provision. The 1964 act contains the germ of this proposal, now applicable only to a tiny handful of charitable donors, but capable of extension to all of them.⁴⁷

⁴² It has been pointed out frequently that this language is misleading. One cannot deal at arm's length with himself. He may, however, arrange a transaction which is fair, in the sense that it is the equivalent of a deal which might be made with another at arm's length, and presumably that is what the committee had in mind.

⁴³ Int. Rev. Code of 1954, § 503(c)(2). See *Railway Equipment Co. v. United States*, 161 F. Supp. 590 (Ct. Cl. 1958).

⁴⁴ Int. Rev. Code of 1954, § 503(c)(1). Such a prohibition is imposed on foundation-to-fiduciary loans by the American Law Institute's Model Non-Profit Corporation Act, § 27 (revised 1957). See 32 Ill. Ann. Stat. § 163a 26 for the corresponding provision of Illinois' version of the act.

⁴⁵ Int. Rev. Code of 1954, § 503(c)(4).

⁴⁶ Int. Rev. Code of 1954, § 503(c)(5).

⁴⁷ In its provisions concerning the unlimited charitable deduction, the 1964 act adds a new set of restrictions analogous to those in the prohibited transactions

The Senate committee to the contrary notwithstanding, it is not possible to deal with oneself at arm's length, however a transaction may resemble arm's length dealing. A ban on all self-dealing would be an improvement over the present scheme in three ways: (i) It would avoid some temptation to some donors to engage in dealings which do not resemble arm's length deals. When foundations are founded for essentially non-charitable motives, and when some kinds of self-dealing for private advantage are permitted, it takes a substantial degree of self-restraint on the part of the donor to refrain from engaging in other kinds of self-dealing for private advantage. The money was once his by right;⁴⁸ it may still be his to control, even though "independent" trustees are nominally in charge. (ii) The proposed ban on self-dealing would be easier to enforce than are the present vague standards of reasonableness, which make virtually the entire financial and institutional environment relevant. Because violations of the proposed absolute ban would be easier to spot, there would certainly be fewer cases of "unpunished" self-dealing to the detriment of the foundations than there are now. (iii) The use of public resources for private advantage would be avoided, and thus there would be a social gain irrespective of any disadvantages to the foundation.

On the other side, what would be lost if such a ban were enacted? Something might be lost to donors who wished to trade with their own foundations, but the loss to the foundations—that is, to the public—would be minimal. The foundation, especially if it is corporate, is not limited to the "legal list" from which trustees must often choose their investments.⁴⁹ Within the limits of section 504(a)(3), prohibiting investment of accumulated income in such a way as to jeopardize the foundation's exempt purposes, and those of section 501(c)(3), which arguably impose similar limits on the investment of corpus, a foundation may choose from a wide range of prospective investments.⁵⁰ A foundation need

section. A contribution qualifies for the unlimited deduction only if the recipient organization does not, during its taxable year including receipt of the gift or during its three preceding and three following taxable years, engage in a "disqualifying transaction." These include *any* loan to a donor or members of his family or his employee; *any* purchase from or sale to the donor, etc., of "more than a minimal amount" of property or securities; *any* payment of compensation to the donor, etc. Int. Rev. Code of 1954, § 170(g)(4). See note 9, *supra*.

⁴⁸ Even a court may make the mistake of equating funds of a controlled foundation with the donor's "own moneys." See *George Pepperdine Foundation v. Pepperdine*, 126 Cal. App. 2d 154, 160, 271 P.2d 600, 604, *hearing denied*, 126 Cal. App. 2d at 164 (1954).

⁴⁹ See, e.g., N.Y. Membership Corp. Law § 27.

⁵⁰ Compare *Randall Foundation v. Riddell*, 244 F.2d 803 (9th Cir. 1957) with *John Danz Charitable Trust*, *supra* note 35.

not invest in its donor's business, or lend him money, for want of other investment opportunities.

Correspondingly, the donor himself loses little if the "arm's length" standard really is applied. If he is prepared to give adequate security and pay reasonable interest when he borrows, and if he really will (as fiduciary) foreclose on himself (as borrower), then a loan on the same terms can be obtained through regular banking channels. When a donor borrows from his own foundation rather than from a bank, the inference is hard to avoid that he is using the foundation because he knows that it can be counted on not to be too hard on him.⁵¹ The tax law should be brought into line with the law of charitable trusts, and self-dealing should be prohibited.

B. *Condemned Persons.* But whose self-dealing? The present law lists the following condemned persons:⁵²

- (i) the "creator" of the foundation (only if it is a trust);
- (ii) a substantial contributor to the foundation;
- (iii) a member of the family of either of the above (and "family" is defined⁵³ to include only the creator's, etc., brothers and sisters, spouse, ancestors and lineal descendants); or
- (iv) a corporation, fifty per cent or more of the voting control or the value of shares of which is owned by the creator, etc.

Without question, this list should be augmented; it ignores some obvious forms of domination, and some which are not so obvious. Furthermore, the present list can use some additional specificity.

Taking these suggestions in reverse order, the very first category of condemned persons is curiously ambiguous. The term "creator" does not have application to a corporation: whether the coverage of the prohibited transactions section should be extended to "creators" of corporations depends on what is meant by the

⁵¹ Years ago, the American-Scandinavian Foundation held mortgage bonds of the Hecla Iron Works of Brooklyn, the principal donor's company. In 1921, the company's position worsened; there were defaults, followed by extensions granted by the foundation. The factory closed in 1926; in 1927, the foundation realized just under \$95,000 on bonds of a face value of \$295,000. The 1928 annual report of the foundation said: "One consideration in the minds of the trustees in 1924 when the bonds matured was that they did not wish earlier than necessary to embarrass the Hecla Iron Works." p. 4, quoted in Tunks, *The Modern Philanthropic Foundation and Private Property* 141-42 (unpublished graduate thesis in Yale Law Library, 1947).

Now that we are more sophisticated and more regulated, such a statement is not likely to appear in an annual report. Still, it would be surprising to find that the attitudes of donors and their controlled foundations have changed radically.

⁵² Int. Rev. Code of 1954, § 503(c).

⁵³ By reference to Int. Rev. Code of 1954, § 267(c) (4).

term. Who is the creator of a trust? Surely the term includes the settlor. Does it also include the person who makes a declaration of trust (perhaps a bank, to which the prospective trust res has been transferred)? The Code's wording suggests a wish to get away from legal terminology with established meaning,⁵⁴ but no alternative meaning is indicated. The category of "substantial contributor" seems to include one who supplies the property which becomes the trust res, but perhaps the settlor is the creator of the trust, and other persons who may later contribute to the res are the substantial contributors. Probably the best solution is to drop the word "creator" from the section and to spell out that it is intended to include the person who makes the initial contribution to a charitable trust or corporation, whatever he is called under state law, as well as anyone else who makes a substantial contribution thereafter.⁵⁵ The word "substantial" probably cannot be improved upon, although it must vary in meaning according to the size of the charity in question.

The following persons should be added to the list of the condemned:

- (i) the charitable fiduciaries: trustees, directors, officers;
- (ii) partners of the contributor, etc.; his employees, or employees of his controlled corporation;
- (iii) the persons who control any corporation which makes a substantial contribution to the foundation;
- (iv) aunts and uncles; nieces and nephews; sons- daughters- and parents-in-law; the parents of sons- and daughters-in-law;
- (v) any corporation or other entity controlled by the foundation.⁵⁶

Both in the list of condemned persons as it now reads and in the above proposal for extension, there are references to controlled corporations. The attribution rules of section 267(c) should be substituted for the phrase "directly or indirectly" now used. Furthermore, the fifty per cent figure in the present wording seems too high; voting control may be achieved at a lower percentage even in some fairly small corporations. If, for enforcement reasons, an arbitrary percentage is needed, perhaps twenty-five per cent

⁵⁴ Perhaps it was intended simply to include other expressions for the settlor, such as "trustor," the term often used in California.

⁵⁵ The law should make clear that if several persons make such contributions, all are condemned; the present use of the singular ("the creator") leaves room for dispute. See Powell, *supra* note 39, at 64.

⁵⁶ See *Caruth Foundation v. Campbell*, 60-2 USTC ¶ 9780. (N.D. Texas 1960), on appeal by the government to the Fifth Circuit, CCH 1964 Stand. Fed. Tax Rep. 70,806.

would be more appropriate. But if the enforcement machinery can stand to make the inquiry, the test for control suggested by two congressional committees in 1954 in another context seems appropriate:

any kind of control, direct or indirect, whether legally enforceable and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise.⁵⁷

Finally, some specific reference should be made in the provision listing condemned persons to dealings made through other unrelated persons who act as conduits. The Service and the courts will surely read such an interpretation in, even if it is not expressed, but it would be better to be sure. The phrase "directly or indirectly" is hackneyed, but it would serve.

C. *Sanctions.* The present prohibited transactions section lacks effective sanctions. The discovery of a prohibited transaction results in the revocation of exemption under section 503(a), but the revocation relates only to taxable years after notice is given by the Commissioner (and there is usually a period of at least a year between the transaction and notice—maybe more),

unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization.⁵⁸

The corresponding provision denying deductions (for gifts made to an organization which has engaged in a prohibited transaction) is also limited to prospective operation, with a similar exception for intentional wrongdoing when the donor who claims the deduction is a party to the prohibited transaction.⁵⁹ Thus while the most serious revenue losses with respect to an exempt foundation are likely to result from the deductions taken by the donor when he makes his donations, still it is only the exceptional prohibited transaction which permits the retroactive denial of deductions, under the prohibited transactions section.

Perhaps deductions *may* be denied retroactively, however, if the Commissioner relies on the general requirements of section 501(c)(3), arguing that the foundation was not organized and operated exclusively for its exempt purposes. The Regulations note⁶⁰ that the requirements of this section and those of the pro-

⁵⁷ H. R. Rep. No. 1337, 83d Cong., 1st Sess. A65 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 226 (1954).

⁵⁸ Int. Rev. Code of 1954, § 503(a)(2).

⁵⁹ Int. Rev. Code of 1954, § 503(e).

⁶⁰ Treas. Reg. § 1.503(a)-1 (1958).

hibited transactions section are cumulative, not alternative, and the Code should say so explicitly. A retroactive denial of exemption is permitted if the original recognition of exemption was based on a "mistake of law."⁶¹ However, although the doctrine of equitable estoppel does not prevent the Commissioner from correcting such a mistake, he is limited in the exercise of his discretion, and he may not revoke an earlier exemption ruling retroactively if the conduct of the organization is not such as to "estop" it from relying on the original ruling, and if it has done nothing to conceal the activities relied on by the Commissioner to deny exemption.⁶² Of course, if the organization "changes character" and fails to notify the Service, exemption may be denied retroactively to the time of the change.

In the *Auto Club* opinion,⁶³ Mr. Justice Brennan distinguishes the *Lesavoy* case⁶⁴ in such a way as to make clear that the question to be decided in each case is whether the Commissioner has abused his discretion in revoking the exemption retroactively. The opinion hints, but does not expressly state, that a ruling recognizing the exemption of an organization which later engages in a prohibited transaction will be regarded as a ruling based on a mistake of law, and thus come within the rule of the *Auto Club* case. The two situations are distinguishable. In the *Auto Club* case, the Commissioner's earlier ruling was based on a mistake as to the organization and operation of the club, neither of which underwent any change. In the case of a prohibited transaction, however, while the foundation may be properly organized and operated for a time, the prohibited transaction changes the operation; any mistake of law relates to the operation after that time. It is doubtful whether the *Auto Club* analogy would permit retroactive denial of exemption extending back before the year in which the prohibited transaction took place, assuming that the "transaction" is not defined to include the initial organization. If this result is desired, the Code should be amended to make the intention clear.

Although the *Lesavoy* decision did not rest on the prohibited transactions section, since the case involved pre-1950 years, Judge

⁶¹ Int. Rev. Code of 1954, § 7805(b). See, e.g., *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957). Cf. *Birmingham Business College v. Commissioner*, 276 F.2d 476 (5th Cir. 1960) ("material misrepresentation" in exemption application); *Cooper's Estate v. Commissioner*, 29 P-H Tax Ct. Mem. ¶ 60,098 (1960), *aff'd per curiam*, 291 F.2d 831 (4th Cir. 1961) (retroactive revocation of exemption of building and loan association).

⁶² Compare *Lesavoy Foundation v. Commissioner*, 238 F.2d 589 (3d Cir. 1956), with *Stevens Bros. Foundation, Inc.*, *supra* note 30.

⁶³ *Supra* note 61, at 184.

⁶⁴ *Supra* note 62.

Goodrich added a footnote dictum which may embarrass the Service when it attempts a retroactive revocation of exemption based on that section:

Taken as a whole, § 3813 seems to indicate a Congressional intent to allow taxpayers to rely on a certificate of exemption under § 101(6) until revoked prospectively unless the prohibited transaction was entered into for the specific purpose of diverting the organization's funds, which was not the case here. Note that even if the subsection (b) puts the taxpayer on clear notice that he is engaged in a prohibited transaction, and thus not entitled to exemption, he [a significant slip] is still treated as exempt until notified by the Secretary.⁶⁵

These words suggest that it will be argued that Congress has provided a specific remedy in the case of a prohibited transaction, and that retroactive revocations of exemption and denials of deductions will be permitted in such cases only when they fit the terms of the exception in section 503(a)(2) and (e), despite the Commissioner's general authority to revoke exemptions retroactively under section 501(c)(3). If this reasoning prevails, we shall have one more example supporting the argument that the prohibited transactions section has in fact diminished the effectiveness of the general language in section 501(c)(3).

The limitations of section 503 may be illustrated by a hypothetical example. A taxpayer in the fifty per cent bracket donates \$100,000 to his own foundation in 1958. Since his taxes are reduced by \$50,000, the public contributes half the foundation's funds. In 1962 the foundation lends all its assets \$100,000, since the income has been distributed each year to charity in order to avoid claims of unreasonable accumulation) to an insolvent business corporation in which the donor owns less than a fifty per cent interest. In 1964, the exemption is revoked; the loan remains unpaid. The revocation of exemption is plainly proper, but the only meaningful sanction would be the retroactive denial of the donor's deductions. The only argument which might prevail for the government in this case would be that the donor was a "party" to the prohibited transaction, although the loan of foundation money was not made to him but to his corporation. The example in the Regulations suggests that the donor would not be regarded as a "party."⁶⁶

⁶⁵ 238 F.2d at 593 n. 8.

⁶⁶ Treas. Reg. § 1.503(e)-1 (1958). These comments must be read with the usual three-year statute of limitations in mind. Int. Rev. Code of 1954, § 6501(a). If, however, the Service can show that the foundation filed a "false or fraudulent return with the intent to evade tax," there is no limitation period on the collection of the tax due. Int. Rev. Code of 1954, § 6501(c)(1). The filing of a return on Form 990-A which did not make disclosure of a prohibited transaction would surely be regarded as a

The uncertainty in the Commissioner's power to revoke an exemption retroactively under the general language of section 501(c)(3) in a case involving a prohibited transaction, coupled with the fact that prospective denial of exemption is frequently no sanction at all, suggest that the sanctions of section 503 need a complete overhaul. As a general rule, the retroactive denial of exemption *and the donor's deduction* should follow whenever the donor (or a related person, under a new broadened definition of condemned persons) engages in a prohibited transaction, without reference to the donor's state of mind at the time of his donation. Of course there will be cases in which this sanction will be too extreme; some prohibited transactions will surely be inadvertent, and retroactive sanctions will be too severe. As an escape valve, the Commissioner should have the power to withhold the retroactive sanctions when he determines (i) that the prohibited transaction was inadvertent, and (ii) that to deny exemption and deductions retroactively would cause undue hardship. In order to avoid manipulation of the general three-year limitations period, a special long period of limitation should be established for cases of retroactive denial of exemption and deductions under this section. Ten years might be an appropriate period, with a no-limitation exception for cases of fraud.

D. *Analogous Protections under Section 504.* Two of the provisions of section 504(a) also give some limited protection against uses of the funds of an exempt foundation which may endanger its exempt purposes. This section is very limited in its effect—limited first in that it protects only the income and not the corpus of the foundation, and limited again in that its sanction is only a denial of exemption for the taxable year in which improper disposition is made of the foundation's income. Exemption is denied for the year if the income of a section 501(c)(3) organization (other than a church, school, etc.) is "used to a substantial degree for purposes or functions other than those constituting the basis for exemption . . ." or is "invested in such a manner as to jeopardize the carrying out of the charitable . . . purpose" of the organization. Thus, in the example noted above, the foundation's loan to the donor's corporation would surely jeopardize the foundation's exempt purposes, and would justify the denial of exemption for the taxable year, but only if the loan had been made out of

fraudulent return. Years prior to the consummation of a prohibited transaction might be reached (beyond the normal three-year limitation period) on the theory that the transaction commenced upon the foundation's organization, and that the claim of exemption was fraudulent from the beginning; such a theory depends upon evidence of the foundation officials' state of mind.

the foundation's income; since it was made from corpus, the income having been distributed each year, there would be no sanction under this section. Since the sanctions of section 504 are even weaker than those of the prohibited transactions section, and since most violations of section 504(a)(2)-(3) would also seem to be violations of the requirements of section 501(c)(3),⁶⁷ there is little reason to rely on these provisions as protections against self-dealing by controlling donors.

The resources of a controlled foundation may be used for some private purposes which are plainly beyond the reach of any foreseeable prohibited transactions provision. For that reason, the strengthening of the prohibited transactions section cannot be expected to do away with the need for restricting donor control. Presumably a denial of exemption to donor-controlled foundations would be even easier to enforce than would a flat prohibition on all self-dealing, just as the latter prohibition would in turn be easier to enforce than are the present prohibited transactions provisions. But a denial of any exemption at all would be still easier to enforce, and plainly enforcement is not the only relevant concern. The more persuasive reason for doing away with donor control to the extent possible is to add one more weapon in the campaign to lessen the possibility of using the public's charitable funds for private advantage.

III. DONOR CONTROL

It is clear under present law that donor control over a foundation is not, of itself, enough to cause the loss of exemption. In *Barber v. Edwards*⁶⁸ the Service denied exemption to a charitable trust partly because the wife and son of the donor were two of the trust's three trustees; the government abandoned this argument in its brief to the District Court, and the court held that control by the donor did not justify the denial of exemption.⁶⁹ For a time it was thought that the Service was going back on its earlier ruling that donor control was not a fatal defect.⁷⁰ But there seems to be no such concern among the tax bar now.

Proposals for legislative change of this rule range from outright abolition of the exemption of family foundations through the separation of such foundations from ownership of interests in

⁶⁷ See *Randall Foundation v. Riddell*, *supra* note 50.

⁶⁸ 130 F.Supp. 83 (M.D. Ga. 1955).

⁶⁹ *Accord*, *Saint Germain Foundation*, 26 T.C. 648 (1956), *acq.*, 1956-2 Cum. Bull. 8. See *Young*, *supra* note 36.

⁷⁰ See *Young & Galvin*, "Proposed Regulations Do Not Clarify Tax Status of 'Exempt Organizations,'" 5 J. Taxation 298, 299 (1956); A.B.A. Section of Taxation, Report 98 (1956).

controlled business corporations to measures short of abolition designed to reduce the total degree or impact of donor control, either by making the creation of family foundations less attractive or by postponing the donor's deduction until the property he contributes to a controlled foundation is given away to an operating charity. "Abolition," in this article, refers only to the denial of exemption and deductions for contributions; it is not asserted that Congress has the power to abolish family foundations, but it is within the power of Congress to abolish a class of tax-exempt organizations.

A. *Abolition of Donor Control.* There are two basic problems which must be faced if the Code is to be amended to do away with donor control of conduit foundations. First, it must be decided what is meant by "control." Second, the kinds of sanctions, as well as their timing, must be considered.

The easiest-to-draft definition of control would surely be limited to voting control. Exemption might be denied if the donor, along with members of his family, occupied a majority of the seats on the foundation's governing board. The difficulty with such a definition is obvious: it fails to take into account that persons other than members of the donor's family may also be willing to follow his wishes in dealing with what they may consider to be "his own moneys."⁷¹ Perhaps some of this probable subservience can be avoided if exemption is denied when the donor or a member of his family is a member of the governing board, whether or not they have voting control. But there is still no assurance that donors will not dominate the foundations they create from outside the board.⁷² A definition which includes cases of de facto control would be preferable, if a workable definition can be constructed.

In the sections of the Code dealing with grantor trusts,⁷³ an attempt is made to meet a similar problem. For some purposes, a power is considered to be held by the grantor of a trust if it is held by someone who is "related or subordinate" to him; for other purposes, a power is considered to be held by the grantor if it

⁷¹ See note 48, *supra*.

⁷² For some colorful examples of informal donor control, see Note, *supra* note 24, at 491 n.91.

⁷³ Int. Rev. Code of 1954 § 671-78. Congressman Patman referred to these sections in recommending the postponement of deductions for contributions to controlled foundations. See Patman Report (first installment), *supra* note 2, at 133-34. We are here concerned only with the definition of control, and not with the other problems which would be raised by an indiscriminate adoption of all the rules of these sections for use in the foundation context. See Krasnowiecki & Brodsky, "Comment on the Patman Report," 112 U. Pa. L. Rev. 190, 195-99 (1963).

is held by someone who is a "nonadverse party." The latter definition will be of no use to us in dealing with the problem of controlled foundations; ordinarily, the only person with a "substantial beneficial interest" in the funds and operations of a foundation is the attorney general of the state on behalf of the public. "Related or subordinate party" is defined as a nonadverse party who is:

- (1) the grantor's spouse if living with the grantor;
- (2) any one of the following: The grantor's father, mother, issue, brother or sister, an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.⁷⁴

A "related or subordinate party" is presumed to be subservient to the grantor with respect to the exercise of trust powers unless the contrary is proved by a preponderance of the evidence. In order to avoid having the grantor treated as the owner of a "Clifford" trust it is necessary to vest the various powers of disposition of the corpus and income in "independent" trustees, that is, trustees none of whom is the grantor and no more than half of whom are "related or subordinate parties."⁷⁵

Estate planners seldom have difficulty in finding "independent" trustees who are perfectly willing to do what the grantor of a "Clifford" trust wants them to do. In the foundation context, there is no reason to believe that the situation would be different. Then is the answer to be found in a broadened definition of "related or subordinate parties"? Probably not. It is doubtful whether any such definition could succeed, in view of the infinite number of possibilities for finding subservient directors who have no formal connections with the donor: the donor's banker, his attorney, his old friend, his neighbor, to name just a few.

The Service formerly recognized a similar distinction in its tentative exemption policy. Until recently, an organization seeking exemption had to operate actively for a year before a determination letter would be issued, recognizing the exemption.⁷⁶ However, if the organization was "of the community or public type," the National Office would issue a tentative determination letter with-

⁷⁴ Int. Rev. Code of 1954, § 672(c).

⁷⁵ Int. Rev. Code of 1954, § 674(c).

⁷⁶ For expressions of dissatisfaction with this rule, see Rogovin, "Methods and Objectives of the Revenue Service's Audit Program for Exempt Organizations," in N.Y.U. Sixth Biennial Conference on Charitable Foundations 229, 236. It was abandoned in 1963; see note 37, *supra*.

out waiting to observe the first year's operation. "Factors which characterize a community or public organization include responsible public representation on its board of directors or trustees," as well as support by public contributions and the requirement of reporting to a governmental body, such as the attorney general in states which have adopted general reporting laws, or local boards which supervise charitable fund-raising.⁷⁷ The ruling did not spell out what was meant by "public representation," but presumably this is a category of directors or trustees who are even more insulated from the domination of a single individual or family than are the "independent" trustees in the "Clifford" sections. A former Assistant Commissioner noted that "as a matter of practice, the Service strictly limit[ed] the application of this policy."⁷⁸

An analogous suggestion of a need for public representation on foundation boards has come from the Congress. In 1954, the Reece Committee reported:

The suggestion has been made that each foundation should be required to have, upon its board, or as one of its trustees, a member selected by a government agency, perhaps the state government. The purpose of the suggestion is that the public would thus have a direct representative who could watch the operations of the foundation and take whatever action he might deem necessary if he found a violation of good practice or law. The suggestion may have merit; it may well be worth the consideration of the Committee on Ways and Means.⁷⁹

The committee did not consider the question of "public" trustees apart from the suggestion of governmental representatives, and thus did not have to face up to a definition of the kind we are seeking. The committee's suggestion apparently has not been considered seriously by the Committee on Ways and Means.

In any case, the difficulty of defining "public" or "independent" trustees is a sizable obstacle to any legislative proposal aimed at abolishing donor control of exempt foundations. One solution might be to use a word like "subservient," along with an illustrative definition including, but not limited to, members of the family, employees, etc., and to leave it to the Service and the courts to make case-by-case determinations concerning *de facto* donor control.⁸⁰ This is a tempting answer, but one which would make

⁷⁷ Rev. Rul. 54-164, 1954-1 Cum. Bull. 88, 90; Rev. Proc. 62-301, 1962 Cum. Bull. 512, 513.

⁷⁸ Sugarman, "Current Issues in the Use of Tax-Exempt Organizations," 34 *Taxes* 795, 799 (1956).

⁷⁹ H. R. Rep. No. 2681, 83d Cong., 2d Sess. 215-16 (1955).

⁸⁰ Compare the generalized language of Regulations § 1.6033-1(g)(iii), "related or associated persons," dealing with the exemption from filing information returns

foundation planning unduly hazardous and the Service's supervisory task nearly impossible. The best solution out of a generally unsatisfactory lot would seem to be a voting control rule, based on a definition similar to that in the "Clifford" sections: a list of "related" directors and trustees, perhaps including a wider range of relatives and other presumptively subservient persons.⁸¹

The second big problem in abolishing donor control relates to the choice and the timing of the sanction to be imposed. Should a controlled foundation's exemption be denied, or should the sanction be limited to denying the dominating donor his deductions? Suppose an outsider contributes to such a foundation; should he be allowed a deduction? Even if the organization is non-exempt? With a few exceptions (as, in the timing of exemption revocation and denial of deductions in the case of a prohibited transaction) exemption and deductions go together, but there is no reason why this has to be so. No doubt it is far more convenient for the Service to have the two tied together—either an organization is exempt or it is not. But the splitting apart of these two incidents could hardly be attacked as too complex a legislative scheme for the Internal Revenue Code.

The exemption, not the deduction, was the main source of the Textron problem. The prohibition on unreasonable accumulations in section 504(a) (1) solves much of that problem; no longer is it possible to "capitalize the exemption" to build a source of investment capital for the donor's business. If a conduit foundation's income is paid out regularly to operating charities, and if the corpus is committed irrevocably to ultimate charitable disposition, there is no reason for great concern about the foundation's exemption. It is the charitable-contribution deduction which is now the principal cause for concern. When a foundation's public funds are used for private advantage, the main governmental subsidy has already been paid in the form of the revenue lost because of the income tax (or estate tax) deduction.

Then why not permit a controlled foundation to keep its exemption, but deny its dominant donor his deductions? The result in practice would surely be the immediate conversion of a great many family foundations into "independent" ones, by substitution of independent trustees for donors and related persons. If, however, some family foundations were to remain under the control of their founders, might we not tolerate them? A negative answer is suggested if there is in existence a substantial number of family foundations whose donors have already given all they plan to

granted by Int. Rev. Code of 1954, § 6033(a) (3) to charities supported by the public.

⁸¹ For such a broadened list, see text at note 55, *supra*.

give. For these foundations, the sanction of denial of deductions would be no sanction at all, unless the law could somehow be applied retroactively to reach deductions made in previous years. Such a provision surely would not get through the Congress, and would probably be unconstitutional if it did.⁸² Even donors who planned to make future contributions would likely wait until they were ready to do so before re-structuring their foundations to give up control. If the public is to recoup in public-welfare benefits what it has lost through deductions, then the denial of exemption for controlled foundations is the only sanction available which will reach all such foundations.⁸³

Any attempt to abolish donor control must rest on the denial of deductions made by the controlling donor. But it is not enough to provide simply that deductions will not be allowed to the donor under those circumstances. Such a provision would not cover the case in which a donor makes a contribution to a foundation which he later comes to control. It would not be hard to imagine such a case: The Jones Foundation, composed of three directors—Mr. Jones' attorney and his two secretaries—accepts a contribution from Mr. Jones. Since the foundation is not controlled by him, Mr. Jones may deduct the amount of his gift. Sometime later, after the exemption letter is issued, the directors resign, one at a time; each resigning director is replaced by a member of the Jones family. Exemption may then be denied, but the major revenue loss has already taken place. The 1950 House bill, in its provision relating to deductions for contributions of stock in the donor's controlled corporation, failed to block this obvious path around its wording.

One way to plug this gap would be to provide for retroactive denial of a donor's deductions if he should acquire control over the foundation. Perhaps a special extended statute of limitations should be provided for such cases, since some donors might be perfectly willing to make their contributions and then wait for three years before taking control of their foundations. It might be argued that such a retroactive deduction denial provision would be unnecessary if *exemption* were to be denied retroactively in the case of an

⁸² See *Brushaber v. Union Pac. R.R.*, 240 U.S. 1, 20 (1915) (dictum).

⁸³ The case of the outsider who makes a contribution to a family foundation is rare enough that it need not be given great weight in making these decisions. However, it is not outrageous to suggest as one possible solution that the denial of exemption to the family foundation need not necessarily result in a disallowance of the outsider's deduction. He has given up his property; it is beyond his control and is committed to final charitable disposition; in the meanwhile it may be used for someone's private advantage, but not his. The problem of defining an "outsider" is essentially the inverse of that of defining donor control.

assumption of control. However, the wording of the retroactive deduction denial provision of the prohibited transactions section makes possible the inference that deductions are not to be denied retroactively except in cases expressly noted in the Code.

B. *Proposals for Change Short of Abolition of Donor Control.* Because of the difficulty of drafting an effective definition of an "independent" board, or because of the attitude of influential members of the Congress,⁸⁴ it may be determined that the abolition of the exemption for donor-controlled foundations should not be sought. There are, nevertheless, some possibilities short of such a measure for reducing or keeping in check the total extent and impact of donor control. The percentage of an estate which might be given to a family foundation on death might be limited, by placing a percentage limit on the allowable estate tax deduction. Or the dollar amount of deductible gifts might be limited for both estate tax and gift tax deductions.⁸⁵

More importantly, the birth rate of new family foundations would surely be diminished if the law were to eliminate the profit in certain kinds of giving to charity: *e.g.*, the valuation of gifts of appreciated property at their market value; the giving of income or annuity interests, valued in accordance with the Treasury's 3½ per cent tables. Wholly apart from considerations relating to family foundations, the elimination of these "profitable giving" devices seems justified.⁸⁶ When a gift to charity costs nothing, or even profits the giver, it is doubtful that the charitable use of the gift property will receive the deliberation it deserves. There is a respectable school of thought which holds that charitable giving should always cost the giver something, not simply for the improvement of his soul, but so that he will have to decide on the usefulness of what he is doing. Whether the presently available practices amount to an "abuse" of the exemption depends on one's definitional preferences. Whatever it is called, in such a transaction

⁸⁴ Supporting an application for exemption of such a foundation on behalf of a constituent is a fairly inexpensive way for a congressman to do a favor.

⁸⁵ See Note, "The Modern Philanthropic Foundation: A Critique and a Proposal," 59 Yale L. J. 477, 504 n.176 (1950); Latcham, "Private Charitable Foundations: Some Tax and Policy Implications," 98 U. Pa. L. Rev. 617, 648-49 (1950).

⁸⁶ Concerning gifts of non-income-producing property, see Rogovin, *supra* note 76, at 246-48. Some of the problems noted in the text are not new. See Miller, "Gifts of Income and Property: What the Horst Case Decides," 5 Tax L. Rev. 1 (1949); Griswold, "Charitable Gifts of Income and the Internal Revenue Code," 65 Harv. L. Rev. 84 (1951); Bittker, "Charitable Gifts of Income and the Internal Revenue Code: Another View," 65 Harv. L. Rev. 1375 (1952). The 1964 act dealt with one kind of profitable giving, denying a deduction for a gift of a future interest in intangible property, *e.g.*, a painting. Int. Rev. Code of 1954, § 170(f).

the government pays the taxpayer a bonus for arranging his affairs to reduce the government's tax revenue. Such a double revenue loss is justifiable only on the very dubious assumption that the public benefits *more* from the charity's use of the contributed property than it would from the lost revenue.

Although these "profitable giving" devices do not require donor control in order to be successful, some estate planners say that a great many—perhaps most—of the family foundations recently created have been formed to receive gifts of this profitable variety. Even if the Code were amended to do away with the profit in giving (for example, by limiting one's charitable-contribution deduction to his basis for the property given, or allowing a deduction at market value but recognizing income to the donor in the amount of the appreciation, or abandoning the rigid use of the 3½ per cent tables in favor of a more realistic evaluation of a charity's income or annuity interest), some controlled foundations would remain. Since the principal unjustified revenue loss arises from the deduction taken by the donor at the time of his contribution, other proposals for reducing the impact of donor control would defer the deduction in time, or limit it in amount.

A deduction might, for example, be denied to the taxpayer who contributes to his controlled foundation until such time as the foundation makes its own gift (of either corpus or income) to another charity. (We are concerned here with a family foundation which does not engage in charitable operations of its own, but rather acts as a conduit for the donor's giving.) Such a principle would make the revenue loss to the government coincide with the compensating *effective* disposition of the property to charitable operations, but the suggestion is not free from problems:

(i) What should the amount of the deduction be? It might be the value of the gift made by the controlled foundation to the operating charitable organization at the time of that gift. This valuation has the merit of being convenient, but if the property has appreciated in value in the hands of the foundation there will be no tax on the increase in value unless the foundation is non-exempt. Such a principle of valuation might thus permit a donor to get around any new legislation designed to limit the profit to be made by giving appreciated property to charity.

To avoid this result, the valuation of the contribution might be fixed at the value of the property when the donor contributes it to the foundation. One serious difficulty with this latter proposal is that the foundation may sell or exchange property or reinvest its income [within the limitations on accumulation in section 504(a)(1)], and it may be impossible to trace any single gift from

the foundation to an operating charity back through such transactions to the donor's original contribution. Furthermore, there would be some formal inconsistency in denying the deduction at the time of the initial contribution on the theory that the donor has not really given his property away, and at the same time valuing his gift as of that time for the purposes of allowing a later deduction. In order to avoid that inconsistency, and at the same time to prevent the use of a controlled foundation to sidestep any new rules about gifts of appreciated property, the solution seems to be (a) to allow the deduction in the year when the foundation gives the property to an operating charity, and (b) to value the contribution in the full amount of the property's market value at that time, but (c) to recognize income to the donor to the extent of the appreciation of his property during the time when it has been held by him *and* by his controlled foundation; the donor should not be permitted to take advantage of any depreciation in value while the property is in the hands of the foundation.

(ii) Would this postponed-deduction proposal be inconsistent with the new carry-back and carry-forward rule which permits a donor to make level contributions to operating charities during a period of fluctuating income? If the carry-back and carry-forward rule can be adapted to a legislative package which also denies exemption (and deductions) when a foundation is controlled by the donor, then there is no need for postponing the donor's deduction; the foundation, as a non-exempt organization, will simply take *its* charitable deduction when it contributes to other charities. If the new carry-back rule is not accompanied by legislation denying exemption to controlled foundations, then the postponement of the donor's deduction will not cause any serious accounting difficulties. The donor can consider the foundation's gift to an operating charity to be his own, made at that time; that gift can be carried forward or back within the prescribed time limits, just the same as any other gift which he might make to a non-controlled charity.

It will be noted that any proposal to postpone a deduction until the contributed property is given to a non-controlled charity will involve the legislative draftsmen in the problem of defining control, with all the complications noted above.⁸⁷

(iii) How long should the controlled foundation be permitted to hold contributed property before giving it to an operating charity? Or, to put it more precisely, should there be a limitation period the running of which will cut off the donor's right to a deduction even though the foundation passes the property on to another charity? The answer seems clearly to be affirmative, both

⁸⁷ See p. 204 *supra*.

because it would be intolerable to open up taxable years which are very far back and also because it is desirable to encourage controlled foundations to make donations of corpus to charities which will put the funds to work.⁸⁸ The only remaining issue is the length of the limitation period; three years seems long enough for this purpose.

(iv) All of the above discussion has assumed that the context was the income tax deduction; suppose that the deduction in question is an estate tax deduction? In such a case there is no question of re-opening an old taxable year, but there is, in the estate tax case, a difficult matter of probate administration to consider. If the estate tax is paid without taking a charitable deduction into account, and then the controlled foundation gives the contributed property to an operating charity, the resulting refund will have to be distributed to heirs and legatees, who will owe more inheritance taxes and whose shares may conceivably be distorted by the two-step distribution. In the case of the estate tax deduction, the solution would seem to be to require the controlled foundation to give the property to an operating charity in time for the deduction to be claimed on the estate tax return; such a rule would still give a 15-month period after death for the foundation to select the charities which are to receive the property.⁸⁹

(v) We have noted the difficulties of tracing property. Suppose that a donor gives property regularly, during his lifetime, to a controlled foundation; then, on his death, he makes another bequest to the same foundation. When the foundation makes a gift to another charity, is the donor entitled to an income tax deduction for his last taxable year (within the allowable limitation period), or an estate tax deduction (within the allowable limitation period)? Presumably he should not get both. One solution might be to allow the donor's personal representative to choose, but the more sensible answer seems to be to limit this donor to the estate tax deduction. There is no reason for picking out the last taxable year rather than some other year between the time of the donor's contribution to the family foundation and the time of his death. The only argument for allowing an income tax deduction (or the

⁸⁸ There is an additional argument which is weaker: failure to provide for such a cut-off period may allow a donor to ride the market. This argument is weak, since riding the market up also would cause the donor to realize income in the amount of the appreciation, and riding it down would reduce the amount of his charitable deduction as a compensation for any reduction in the amount of his taxable gain on the property.

⁸⁹ There would be no similar gift tax deduction problem, since the gift would be treated as made only at the time when the controlled foundation passed the property on to an operating charity.

opportunity to choose) under these circumstances is that the year of death is normally not foreseeable, and the donor's income tax rate may be higher than the estate tax rate.

C. *Prohibition on Family Foundation's Ownership of Interests in Donor's Business.* The revenue bill which passed the House of Representatives in 1950 included a provision designed to discourage donors from contributing stock in their own businesses to their own controlled foundations. The bill was not concerned with the exemption of organizations which already owned such stock or which might acquire it in the future. Instead it denied a charitable-contribution deduction, in the words of the Ways and Means Committee,

for income, estate, and gift tax purposes if both of the following conditions are present:

(1) The contributor, or members of his family, have voting control of the organization to which the contribution is made, and

(2) The contribution consists of stock in a corporation in which the contributor together with members of his family control 50 percent or more of the voting stock or 50 percent or more of the total stock, counting the stock held by tax-exempt organizations which the family control.⁹⁰

The committee's motive for recommending this provision was not made clear in its report:

Frequently families owning or controlling large businesses set up private trusts or foundations to keep control of the business in the family after death. This is accomplished by leaving the business either at death or during life to one of these family trusts or foundations. Bequests or gifts to such a trust or foundation are at present allowable deductions for estate, gift, and income tax purposes. To prevent the avoidance of income, estate, and gift tax liability in such cases, your committee's bill provides . . .⁹¹

It is hard to tell whether the committee's primary concern was over the loss of revenue or over the use of the foundation device to assure the retention of control in the family. Evidently the Senate Finance Committee assumed that it was the latter point which concerned the House. In eliminating this provision from the 1950 legislation, the Senate committee said:

The House report expressed the view that denial of deductions in such cases would simply be a recognition of the fact that where such control exists no completed gift for which a

⁹⁰ H. R. Rep. No. 2319, 81st Cong., 2d Sess. (1950), reprinted in 1950-2 Cum. Bull. 380, 414.

⁹¹ *Id.* at 413-14.

deduction should be granted has been made. In the opinion of your committee this overlooks the fact that the donor or his family must use the property set aside in the foundation or trust for charitable, etc., purposes rather than for personal purposes.⁹²

The committee added that the loss of revenue in such cases was outweighed by "the fact that if these deductions are not allowed still larger funds would be lost to private charity."⁹³

These rather cryptic remarks by the two committees are not very illuminating, but they do contain the germs of most of the ideas which underlie current dissatisfaction with joint foundation-corporation control arrangements: the revenue loss is not justified if the property contributed is still controlled by the donor for private purposes; the foundation's interest may be used to manipulate the corporation for the donor's private interest as opposed to that of the other shareholders; and the foundation itself may suffer from its investment in the donor's business.

The latter two objections to common foundation-corporation control are merely more particularized applications of the above-developed objections to donor control and self-dealing. (The phrase "common foundation-corporation control" is used here to refer to the situation in which a controlled foundation owns stock in the donor's controlled corporation, and not simply to a case in which the same person controls both a foundation and a corporation.) Passing the control of a business from one generation to another within a family through the use of a controlled foundation is harmless in some cases. In every case, however, it carries with it the danger that the management of the corporation will be left in the wrong hands, perhaps those of the children of the corporation's founder, just because they are able to vote the foundation's stock. If the corporation also has other shareholders, such a perpetuation of management will be an intolerable use of public resources for purposes of preferring one private group over another.⁹⁴ And even if there are not other shareholders involved, the community has an interest in seeing that dead-hand control does not impose inefficient management on its enterprises.

When a corporation is run not for the corporate good of all its owners but rather for the private benefit of a management clique, Equity will traditionally supply a remedy. When the Senate Finance Committee said that a foundation's property must not be used "for personal purposes," it no doubt had in mind the analo-

⁹² S. Rep. No. 2375, 81st Cong., 2d Sess. (1950), reprinted in 1950-2 Cum. Bull. 483, 511.

⁹³ *Id.* at 512.

⁹⁴ See text at note 19, *supra*.

gous doctrine which requires charitable trustees to manage their trusts for the benefit of the public's beneficial interest in charity; in this context, the interest of the public resembles that of a corporate shareholder outside the management group. Common foundation-corporation control thus involves the danger of the opposite kind of abuse: not manipulation of the corporation through the foundation, but abuse of the foundation for the benefit of the corporation.

It may be excessively risky for any charitable organization to invest a very large proportion of its resources in a single enterprise. Partly for this reason, but mainly in order to reduce foundation control over some businesses, the Reece Committee suggested that it would be proper for the Congress to give consideration to a scheme which limited tax-exempt foundations to an investment of a maximum of five or ten percent of their capital in one enterprise.⁹⁵

Apart from the investment risk of putting all a foundation's capital in one basket, there are other reasons why the separation of foundation and corporation control may help protect the foundation. It may be that a donor who controls both a corporate business and a family foundation will find self-dealing more tempting than will other creators of controlled foundations. Professor Sacks, arguing for a return to the separation principle of the 1950 House bill, suggests that a separation of control will go far to meet two conditions: the avoidance of transactions between related persons and organizations, and the avoidance of foundation activities which are especially beneficial to related persons or organizations. He hints that an improved prohibited transactions provision might achieve part of these purposes, but adds, "I doubt that these conditions can be satisfied in cases where the donor has given to his foundation stock control of one or more corporations and proceeds to manage both."⁹⁶

Prudent investment policy may dictate that the foundation sell its stock in the donor's corporation; yet the donor may be reluctant to give up management control, so that the foundation will be prevented from selling. Or, good investment management may dictate an attempt by the foundation, as shareholder, to remove the corporation's directors and officers—just as the Kress Foundation threatened to do several years ago. Yet when those same directors control the foundation as well as the corporation, their jobs are probably safe. The foundation may need income for its exempt purposes; if the corporate management decides not

⁹⁵ H. R. Rep. No. 2681, 83d Cong., 2d Sess. 216-17 (1955).

⁹⁶ Sacks, "Use and Misuse of the Private Foundation," in N.Y.U. Fifth Biennial Conference on Charitable Foundations 203, 216 (1961).

to pay dividends, perhaps in order to take the earnings out later in the form of capital gains, there is nothing to protect the foundation. All of these are real possibilities, not fanciful imaginings. In each of the above cases, the complexity of the factors relevant to decision would make the state's attorney general reluctant to assert that there has been a violation of fiduciary duty except on the clearest kind of evidence of wrong-doing. These are likely to be subtle practices; of course none of them is a prohibited transaction within section 503, except arguably as an improper "diversion" of the foundation's income or corpus—and that is a weaker argument than the Service has yet been willing to try in this area.

So much for the special dangers of common foundation-corporation control. What technique might be used to prevent it? The starting place is the House proposal of 1950. That proposal did not attempt to reach the exemption of the foundation member of a controlled foundation-corporation combination. Rather it was limited to the denial of a deduction for a contribution of stock in a corporation controlled by the donor to his own controlled foundation.⁹⁷ There are several reasons why this proposal is inadequate.

The House bill did not impose any sanction on existing donor-controlled foundations which already owned stock in donor-controlled corporations. Perhaps it was thought sufficient in 1950 to deal with the future creation of common control arrangements, but there is no reason now for limiting the attack to the future. Secondly, the 1950 House bill is limited to a denial of deductions in the case in which the "common controller" makes the contribution. If A controls A Corporation and A Foundation, and B—an unrelated person—contributes some A Corporation stock to the A Foundation, the 1950 proposal imposes no sanction. This limitation leaves open the possibility of an exchange of stock between two potential donors, followed by cross-donations to each other's foundations; the Service might assert in such a case, on a *Court Holding Company* theory,⁹⁸ that each donor had really given stock in his own company to his own foundation, but the language of the proposal was not specific. Even if there is no exchange of stock, but simply a donation by an outsider, the subsequent common control is as objectionable as if the "common controller" himself had made the contribution, with the exception that *he* has taken no deduction and caused no loss of revenue.

A further defect of the 1950 House proposal is that it is unimaginative in its definitions of control; only the contributor,

⁹⁷ For the Ways and Means Committee's "detailed discussion" of this provision, see 1950-2 Cum. Bull. 473-74.

⁹⁸ See *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

members of his family, and his controlled trusts and corporations are regarded as owning stock or holding managerial control on the contributor's behalf. At a minimum, this category should be broadened to include various other relatives, employees, employees of controlled businesses, etc., as suggested in the above discussion of the "Clifford" sections.⁹⁹ The House bill also failed to consider the possibility that a contributor might make a contribution of stock in his controlled company to a foundation which was not at the time controlled, but then assume control after contributing and taking his deduction.

Finally, and perhaps most important, the donor might simply give cash to his controlled foundation, and then have the foundation buy stock from him. There would be no prohibited transaction (under the present law) if the price were fair, and there would be no denial of a deduction at the time of the contribution of cash under the House bill of 1950. It is no wonder that Professor Sacks expressed doubt that the language of the House bill was adequate to accomplish the purpose of ending common foundation-corporation control.¹⁰⁰

Any proposal to end common control over corporations and exempt foundations must begin with a definition of control. The above discussions¹⁰¹ are relevant here with respect to control over the foundation; as for the corporation, the fifty per cent rule of the House proposal does not take into account that in many corporations something less than fifty per cent is sufficient for voting control. Furthermore, common control is not the only evil which ought to arouse our concern; as noted above, it may be poor investment policy to keep a large portion of the foundation's capital tied to one company. As a consequence, two different types of percentage limitations on foundation ownership interests in a single corporation may be proposed: a maximum percentage of the corporation's stock, and a maximum percentage of the foundation's capital.

In 1951, the State of New York adopted a statutory authorization for corporations to give to charity

provided that a contribution shall not be authorized hereunder if at the time of the contribution or immediately thereafter the donee institution shall own more than ten per centum of the voting stock of the donor corporation or one of its subsidiaries. . . .¹⁰²

In the province of Ontario, the Charitable Gifts Act, 1959, requires

⁹⁹ See text at note 73, *supra*.

¹⁰⁰ Sacks, *supra* note 96, at 213 n.5.

¹⁰¹ Sections II.B. and III.A., *supra*.

¹⁰² N.Y. Gen. Corp. Law § 34.

any person who receives an interest in a business for profit in any capacity for charitable, etc., purposes to dispose of any portion of the business which represents more than a ten per cent interest in the business.¹⁰³

The exemption might be denied if a foundation were to hold more than ten per cent (or five per cent) of a corporation's stock, calculated either by voting power or by value. Additionally, exemption might be denied if more than ten per cent (or five per cent) of the foundation's capital were invested in a donor-controlled company.¹⁰⁴ While these two complementary suggestions would not avoid all common foundation-corporation control, they would certainly help.

If exemption is to be denied because the foundation owns too much stock in a given corporation, it may be advisable to include a provision which gives the foundation a grace period in which to dispose of its excess holdings. The Ontario statute allows a period of seven years for this purpose, and gives the courts permission to extend the grace period as they think proper. A seven-year period is surely too long in the case of a controlled foundation which owns stock in a donor-controlled company. Exemption might be denied if at the end of the taxable year the controlled foundation owned more than ten per cent of the stock of a donor-controlled corporation, unless the excess over ten per cent had been acquired during that same taxable year.

A tightened version of the 1950 House bill would thus add provisions such as the foregoing relating to the denial of exemption; broaden the class of persons included in the definitions of control; deal specifically with the case of indirect contributions through a non-related party; and provide for retroactive denial of deductions (and exemption) in the case of an assumption of control over the foundation after the gift of controlled-corporation stock, and in the case of the purchase of such stock by the foundation with cash or other property, contributed by the donor or not.

IV. CONCLUSION

The potentiality for abuse inherent in the tax exemption of family foundations does not require a general overhaul of our exemption system; these are narrow problems, in need of particularized narrow solutions. One political obstacle to the kind of reform here suggested is that it is so easily confused with a general

¹⁰³ Ont. Stat. 1959, c. 13, § 2.

¹⁰⁴ Such a proposal was made in Note, *supra* note 85, at 506, and picked up by the Reece Committee, H.R. Rep. No. 2681, 83d Cong., 2d Sess. 217 (1955).

attack on voluntary private philanthropy in general. Let there be no mistake about it: private philanthropy in general and foundations in particular are worth preserving and promoting.

Foundation funds are public funds, however. They are permitted to remain in private hands because important social purposes are served by the decentralization of decision-making and by the insulation of foundation programs from political and other pressures which are normally operative within government. When funds in the public treasury are manipulated for private gain, we call it graft. There is no reason to invent new euphemisms to describe similar dealings with public funds which are privately managed.

The converse of the political dilemma of the reformer is that abuses by some foundations of their privileged status make all foundations suspect in the eyes of a public which takes its information from congressional press releases. It is the operating foundations—the genuine educational and charitable undertakings—which stand to lose the most in the predictable backlash from the exposure of self-dealing and other abuses inherent in donor control. The natural leaders of the campaign to enact these reforms are the foundations themselves.¹⁰⁵

¹⁰⁵ See Sacks, *supra* note 96, at 214. One leader in the foundation world, Dr. F. Emerson Andrews, has been a consistent advocate of strict self-imposed standards for foundation management.